The Difficulty Behind Securing Sector-Specific Investment Establishment Rights: The Case of the Energy Charter Treaty

SAAMIR ELSHIHABI*

I. Introduction

Very little attention is paid to pre-investment[1] protection in international agreements dealing with foreign investment. Often, the protections secured by an international agreement such as a bilateral investment treaty (BIT), can only be triggered after the investment has been made.[2] In effect, very few provisions in international agreements grant a right to investment by a foreign investor in a state. In addition, most BITs outline specific exceptions to national treatment and most-favored-nation (MFN) treatment. These exceptions normally fall within strategic sectors such as defense, energy, and telecommunications.[3] One

*Saamir Elshihabi is a graduate of Columbia Law School and is currently an associate at the international law firm of Shearman & Sterling in New York, where he specializes in international investment law and international business regulation. This article represents the author's views and does not represent the view of Shearman & Sterling.

1. Throughout this paper, pre-investment, making investments, and establishment of investment will be used interchangeably. They all refer to the process of accessing investment opportunities.

2. *See generally* OECD, POLICY BRIEF, No. 2–1997, MAI: THE MULTILATERAL AGREEMENT ON INVESTMENT 3 (1997), *available at* http://www.oecd.org/publications/pol_brief/1997/9702_POL.HTM; Untitled Agreement Between the United States and South Korea, July 1, 1989, 30 VA. J. INT'L L. 184 [hereinafter U.S.-S. Korea Agreement] (stating that all foreign investment will be accorded national treatment "once established"); MOHAMED I. KHALIL, TREATMENT OF FOREIGN INVESTMENT IN BILATERAL INVESTMENT TREATIES 24 (1992) (most BITs only obligate states to "endeavor" to "encourage" investments and can admit investments "subject to their own laws" or "in conformity with national law"). The exceptions to this broad generalization can be found in the draft version of the Multilateral Agreement on Investment, *available at* http://www.citizen.org/pctrade/MAI/What%20is/mainewte.htm [hereinafter Draft MAI]; North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 605, 673 [hereinafter NAFTA]; U.S. BILATERAL INVESTMENT TREATY PROGRAM (1997) [hereinafter U.S. BIT].

3. *See generally* Treaty Concerning Business and Economic Relations, Mar. 21, 1990, U.S.-Pol., 29 I.L.M. 1194, §§ 1, 4 (1990) [hereinafter U.S.-Pol. BIT]; U.S.-S. Korea Agreement, *supra* note 2 ("Exceptions to national treatment may only be applied for reasons of land acquisition, exploitation of land or other resources or national security"); Treaty Between the United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment, Nov. 14, 1991, 31 I.L.M. 128, protocol §§ 2, 4 (1992) [hereinafter U.S.-Arg. BIT] (BIT allows the United States to maintain limited exceptions to national treatment in twelve sectors, and it allows Argentina to maintain exceptions in nine sectors).

of these areas—energy—is now the subject of a multilateral treaty that came into force in 1998. The Energy Charter Treaty[4] (ECT) is the first multilateral, sector-specific investment treaty to gain support from Europe, states comprising the former Soviet Union, Japan, and Australia.[5] According to one diplomat, "the [ECT] represents the 'State of the Art' in the development of multilateral agreements for the promotion and protection of international investment."[6] Though the United States participated in the negotiations, it did not sign or ratify the ECT.[7] Today, the ECT is in force; however, pre-investment concerns are not adequately addressed within it. As a result, work to conclude a Supplementary Treaty to the ECT, whose goal was to clarify binding pre-investment rights, began soon after the ECT was signed.[8] For reasons that will be further explained in this paper, the Supplementary Treaty was never finalized, and eventually states ceased their negotiations on the agreement.

In this paper, I describe the evolution and impediments towards the Supplementary Treaty specifically, and towards sector-specific pre-investment regimes generally. Part II describes the contours of how states generally treat pre-investment rights. This section also sets forth some peculiarities in energy investments, including the importance of sovereignty over natural resources, exceptions taken specifically for the energy sector in other investment treaties, and the mechanics of how energy investments are made. Part III explains the evolution and provisions of the ECT, with a focus on its treatment of pre-investment rights. Part IV explores the specific treatment that was to be accorded by the Supplementary Treaty, including the exceptions incorporated and issues left outstanding. Part V presents my conclusions on the lessons to be learned for future sector-specific investment treaties.

---

4. Energy Charter Treaty, Dec. 1994, 34 I.L.M. 360 (1995) [hereinafter ECT].

5. *See* Ian Forsyth, *Australia Signs an Energy Charter Treaty*, *available at* http://www.dfat.gov.au/ipb/images/insight/ins43/energy.html (last visited Oct. 25, 1998) (printout on file with author).

6. *Id.*

7. The United States did not sign the ECT because it felt that the level of protection within the ECT did not rise to the level found in U.S. BIT. *See* United States: Statement on the European Energy Charter Treaty, Dec. 15–16, 1994, 34 I.L.M. 556 (1995); *see also* William Fox, *The United States and the Energy Charter Treaty: Misgivings and Misperceptions*, *in* THE ENERGY CHARTER TREATY: AN EAST-WEST GATEWAY FOR INVESTMENT & TRADE 194, 196 (Thomas Wälde ed., 1996). A letter by Shaun Donnelly, Deputy Assistant Secretary of State for Energy, Sanctions and Commodities, to American business executives hints that the United States thought that the Supplementary Treaty negotiations may have been more important than the ECT. In the letter, Donnelly states,

> I laid down a marker that the U.S. Government believes it is eligible to participate fully in the negotiations on a second treaty covering access to energy resources, de-monopolization, privatization and other 'making investment' economic policy issues. I intend to ensure that U.S. firms are not disadvantaged in any provisions of the second treaty.

Id. In fact, the United States did not participate in the Supplementary Treaty negotiations. Telephone Interview with Lise Weis, Energy Charter Secretariat (Oct. 30 1998).

8. Negotiations on the Supplementary Treaty began in 1995 and all signatory states were invited to attend the negotiations. The United States was also invited because it was felt that U.S. participation was key to developing a solid and well-adhered-to regime. It may be hoped that continued U.S. participation will lead it to consider accession to the ECT in the future. *See Negotiations Start on Second Energy Charter Treaty*, EC ENERGY MONTHLY, June 16, 1995, *available at* 1995 WL 9766001 [hereinafter *Negotiations Start*].

II. Pre-Investment Rights

A. Overview

The development of establishment rights is a recent trend in international investment law.[9] This right protects the investor seeking to make new investments from state measures that discriminate on grounds of nationality, and is distinct from the rights gained after an investment is actually made.[10]

To date, there are two basic theories on how a state can coordinate investment access. The most sweeping is a general liberalization of investment access, or open foreign direct investment (FDI), similar to the European Union's (EU) right of establishment.[11] On the other end of the spectrum is managed FDI, a regime most states use because it allows them to balance national interests with inward investment flows.[12] Because of this balancing, states regard managed FDI as more likely to effectuate fair outcomes.[13] In addition, a managed approach to investment access allows states to effectively control the types of investments open to non-nationals. This approach is important to understand since all countries use a controlled approach to investment access within the energy sector.

Whether a state uses the open or managed approach to foreign investment, it undoubtedly considers the control of inward investment flows as fundamental a sovereign right as the control of immigration. In international negotiations, states place the majority of their energies into defending their discretion to control the establishment of investments in their territories. Specifically, they want to retain their sovereign rights in terms of whom they allow to enter and under what conditions.[14] Even the European Community, which obliges each Member State to institute freedom of establishment for investors of other Member States, still allows states to exclude investments in activities that are connected, "even incidentally, with the exercise of public authority."[15]

---

9. Energy Charter Secretariat & International Energy Agency, Joint Paper presented to the G8 Energy Ministerial in Moscow, para. 47, Apr. 1, 1998 [hereinafter Joint Paper]. The paper states "[t]he subject of investment admission is a relatively new issue in international agreements. Most bilateral treaties do not define obligations relating to the admission of foreign investments." The paper then notes that NAFTA, the Draft MAI, and the Supplementary Treaty to the ECT do address this issue. Some U.S. BITs discuss establishment rights. Recently, the U.S.-Argentina BIT granted citizens from each state, subject to immigration laws, the right to establish an investment to which they "have committed or are in the process of committing a substantial amount of capital or other resources." U.S.-Arg. BIT, *supra* note 3, art. II(3).

10. *See* Joint Paper, *supra* note 9, ¶ 41.

11. Jeffrey Atik, *Fairness and Managed Foreign Direct Investment*, 32 Colum. J. Transnat'l L. 1, 4 (1994). The EU's "right of establishment" concept is bounded by significant controls. *See infra* note 15.

12. Managed FDI can involve the following practices: "(1) investment access can be denied legitimately using case-by-case investment access approvals, as opposed to investment rights; (2) the nationality of an investment source influences investment access determinations; (3) investment access can be linked to other aspects of the international economic relationship, particularly satisfactory trade performance; and (4) fairness principles, based on a balance of economic circumstances, including reciprocity, discipline investment access decisions." *Id.* at 5–6.

13. *See id.*

14. *See* Thomas W. Wälde, *International Investment Under the 1994 Energy Charter Treaty, in* The Energy Charter Treaty, *supra* note 7, at 251.

15. Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 5 [hereinafter EC Treaty]. Article 52 of the treaty abolished restrictions on the "freedom of establishment." *Id.* at 37. Article 53 prohibits the introduction of new restrictions on the right of establishment. *Id.* at 38. Major limitations still

B. Energy Sector Investments

1. *State Sovereignty over Natural Resources*

International law has long granted states total control over the natural resources within their territories. The contours of permanent state sovereignty over natural resources were set out in a 1966 U.N. General Assembly Resolution, in which the General Assembly unequivocally reaffirmed "the inalienable right of all countries to exercise permanent sovereignty over their natural resources in the interest of their national development."[16] Since then, every major international environmental declaration or agreement reiterates the complete sovereign power a state enjoys over its natural resources.[17]

The ECT also recognizes the importance of national sovereignty over energy resources. Article 18, entitled Sovereignty Over Natural Resources, reads, "the Treaty shall in no way prejudice the rules in contracting parties governing the system of property ownership of energy resources."[18] In addition, this article also reserves a state's total discretion in deciding where and when certain geographical areas and energy resources will be available for exploration and development.[19] Even with these broad reservations of power granted to states, the ECT does place a best efforts obligation on states to facilitate access to energy resources by allocating in "a non-discriminatory manner on the basis of published criteria" any authorizations needed to prospect for, or to extract, energy resources.[20]

2. *Energy-Related Exceptions within Bilateral and Multilateral Investment Treaties*

Recent economic agreements explicitly reserve a state's control over its natural resources and energy-sector activities. In the North American Free Trade Agreement (NAFTA) for instance, the first principle in the Energy Chapter requires the parties to "confirm their full respect for their constitutions."[21] This clause was inserted at Mexico's insistence at the start of negotiations because it did not want NAFTA to impinge upon the fundamental energy principles set forth in its constitution, including its right to reserve certain energy-related activities for itself.[22] Later in NAFTA, Mexico reserved the right to control goods, activities, and investments in the oil, gas, refining, basic petrochemicals, nuclear, and electricity sectors.[23] As a result, very few energy-sector activities in Mexico were actually opened to foreign investors through NAFTA.[24]

---

exist in article 55, which excludes activities that are connected, "even incidentally, with the exercise of public authority." *Id.* at 39. Article 56 allows Member States to regulate foreign nationals on grounds of "public order, public safety and public health." *Id.*; *see also* Atik, *supra* note 11 (describing the difference between the EU's "open FDI" policy and NAFTA's "managed FDI" policy).

16. G.A. Res. 2158 (XXI), U.N. GAOR, 21st Sess. (1966).

17. *See* Stockholm Declaration of the United Nations Conference on the Human Environment, June 16, 1972, 11 I.L.M. 1416, principle 21 at 1420 (1972); *see also* Rio Declaration on Environment and Development, June 13, 1992, 31 I.L.M. 874, principle 2 at 876 (1992); Convention on Biological Diversity, June 5, 1992, 31 I.L.M. 818, art. 3 at 824 (1992).

18. ECT, *supra* note 4, art. 18(2).

19. *Id.* art. 18(3).

20. *Id.* art. 18(4). It is unlikely that this best efforts clause will change to a binding clause since the state is often considered to be the sole owner of all the territory's natural resources. In addition, this clause is not subject to the investor-state dispute settlement procedure. *See infra* note 66.

21. NAFTA, *supra* note 2, art. 601.

22. *See* Reinier Lock, *Mexico-United States Energy Relations and NAFTA*, 1 U.S.-Mex. L. J. 235, 243 (1993).

23. NAFTA, *supra* note 2, ann. 602.3.

24. The only activities open to foreign investors in Mexico's energy sector include self-generation electric

The U.S. BIT program also shows that, due to their strategic importance, energy-sector investments are often exempted from national or MFN treatment in bilateral investment arrangements. For instance, in the U.S.-Argentina BIT, an explicit exception is taken by the United States that reserves its right to maintain national treatment exceptions in the regulation of investments and associated activities within the energy and power production sectors, as well as with the use of land and natural resources.[25] While the exception does not affect the right to establish investments, it effectively places Argentinean investors at a disadvantage because the United States may deny national treatment after the specified investments have been made.[26] This same exception is also found in the U.S.-Poland BIT. The difference in the latter case is that Poland has also reserved the same right to maintain limited exceptions to national treatment in investments already made in the energy and power production sectors, including the exploitation of natural resources.[27] Once again, the right to establish an investment in the specified sectors is not directly affected by the exception, however the same result follows that investors are still at risk since discriminatory treatment may arise after the investment has already been made.

3. *How Energy Investments Are Made*

The need for investment traditionally forced states to grant foreign investors broad control over select natural resources. For instance in the petroleum sector, many states granted complete concessions to foreign petroleum companies. These traditional concession agreements granted the foreign investor total control over the use (or non-use) of all mineral resources found within the concession area.[28] In effect, states gave up their sovereign control over these precious natural resources simply to gain the foreign investment.[29]

In time however, states regained and strengthened their control over natural resources. For some states, such as Mexico, control was regained through outright expropriations.[30]

facilities used by the investor for their own use; small power generation facilities of less than thirty megawatts; co-generation facilities that produce both electric power and useful thermal energy; and independent power production facilities that produce electricity for sale of more than thirty megawatts, all of which would be sold to CFE, Mexico's federal electricity commission. *See id.* ann. 602.3(5).

25. U.S.-Arg. BIT, *supra* note 3, protocol § 2.

26. The exception in Protocol § 2 applies only to article 2(1) of the BIT. Article 2(1) requires both the United States and Argentina to grant national or MFN treatment to investments once made. *See id.* at 129. By contrast, article 2(2)(b) prohibits the United States and Argentina from imposing discriminatory regulations affecting the right of each other's citizens to establish investments. *See id.* at 130. Therefore, the exception to energy investments does not technically affect the right to establish an investment, but it can affect the investment once made, on the basis of nationality.

27. *See* U.S.-Pol. BIT, *supra* note 3, ann., §§ 1, 4. The language in these provisions is almost identical to that of the U.S.-Argentina BIT. The difference, as noted, is that both states maintained exceptions in the energy sector, while in the U.S.-Argentina BIT, Argentina's exceptions were worded much more narrowly (atomic energy centers and mining).

28. Ernest Smith, *A Fifty-Year Perspective on World Petroleum Arrangements*, 24 Tex. Int'l L.J. 13, 18 (1989) ("These concessions did not specifically obligate the companies to drill on any of the lands granted or to release territory if exploration and drilling were not undertaken."). Concession agreements in the Middle East were widely used. Typically, the sovereign (king, prince, etc.) received an up-front bonus, shares of stock in the developing investor's company, and a percentage royalty. In return, the foreign investor received exclusive oil rights over a vast geographical area. For instance, William D'Arcy obtained from the Shah of Persia in 1901 exclusive oil rights over 500,000 square miles. *See id.* at 17.

29. "Host states had no right to participate in management decisions, including drilling and development decisions." *Id.* at 18.

30. Mexico's 1917 Constitution declared that all natural resources, such as solid, liquid, and gaseous hydro-

For others, particularly Middle Eastern states, a gradual process towards nationalization of the energy sector granted the regaining of control over energy production and resource management.[31] Today, very few concession agreements are used in new energy exploration ventures, and if they are used, the terms are much more favorable to the host states. In addition, mechanisms called risk-sharing agreements[32] or production-sharing agreements[33] are used to replace traditional concession agreements. In this way, the state retains complete sovereign control and title over its natural resources, while gaining the cooperation, investment, and expertise of the foreign company in the venture.

Even with the better bargaining position states enjoy, the need to secure national sovereignty and control over natural resources still creates tension with the promotion of an open market for the establishment of investment in the energy sector. It is important to understand the historical development of petroleum and mineral arrangements between states and foreign investors because it provides insight into how states have tried to handle this tension. Moreover, this tension in the resource development area coincides with the same strategic concerns that many states have with respect to their electricity and power generation sectors. In fact, in today's global energy market, many of the companies traditionally involved in natural resource development have moved into the electricity sector.

As a result of the substantial state interest in energy development, access to investing in the energy sector is normally regulated through licenses, permits, and contracts.[34] In addition, the state often plays a direct role, since investments in natural resources almost always require negotiations between the investor and the owner of those resources (the state).[35] Because of the size of the energy projects, investors also usually need to obtain a variety of planning and other consents from national and local authorities.[36] This constant interaction between government authorities and investors, prior to the establishment of an energy investment, places foreign investors at a constant risk of being subjected to measures that deliberately discriminate against them.[37]

---

carbons, were vested with the state. This completely reversed Mexico's prior laws that granted a landowner all rights to all resources found on and under their property. In the twenty years since that change, serious disputes arose between foreign oil companies (that owned the lands they developed) and the Mexican government. Finally in 1938, Mexican President Lazaro Cardenas announced the expropriation of all the oil industry. This move effectively banished all foreign oil and energy companies from Mexico. *See id.* at 28.

31. In the Middle East, the original concessions were transformed through renegotiation to ultimately result in a different type of concession agreement, one based on participation and not alienation, by the state. *See id.* at 31.

32. Basically, a risk-sharing agreement is a contract whereby the foreign petroleum company agrees to put up all the exploration and development costs. If a commercially-feasible discovery is made, the company is repaid its exploration and development costs, in addition to a premium for taking on the risk. If a discovery is not made, then the state loses nothing since all of the up front risk was borne by the petroleum company. This differs from the traditional concession agreement in that the investor receives no rights related to the acreage that it develops. *See id.* at 41.

33. A production-sharing agreement (PSA) is very similar to the risk-service agreement. Like the risk-service agreement, the PSA obliges the petroleum company to take all the risk for exploration and development of new petroleum resources. What is different from the risk-service agreement is the form of payment. In a PSA, the company is granted a proprietary right in the future production of the resource, and not a right in the actual acreage as is in the traditional concession agreement. *See id.* at 38.

34. *See* Joint Paper, *supra* note 9, ¶ 41.

35. *See id.*

36. *See id.*

37. *See id.*

And so, the major questions remain: How can governments develop their domestic energy industries with foreign investment without ceding their national sovereignty? Should foreigners be allowed to invest in the energy sector on the same terms as domestic investors? If the amount of foreign domination in the domestic energy sector grows, could the state be strategically threatened by the powerful foreign investor? Answers to these fundamental questions need to be reconciled with the traditional norms governing sovereign control over national energy resources. These questions will be answered, in part, by examining both the ECT and the negotiations on the Supplementary Treaty.

III. The Energy Charter Treaty

A. Evolution of Sector-Specific Agreements Generally and the ECT Specifically

Aside from the gap that BIT exceptions create in international investment law, a number of other factors also promote the development of sector-specific investment regimes. First, cross-border investments in traditionally exempted areas are growing tremendously.[38] With this growth, foreign investors demand greater protections for their investments. Second, fearful of the transient whims of government bureaucrats and no longer having the bargaining power to unilaterally dictate terms to a state, foreign investors are turning to their national governments to negotiate internationally binding and equitable standards for the protection of strategic investments. Third, with international competition in strategic sectors such as energy and telecommunications growing, a call for an international approach to regulation is appropriate.[39]

To address the growing need for uniform rules in the energy industry, the ECT was negotiated. Originally, the treaty process started with a call by the Dutch Prime Minister in 1990 for a pan-European Energy Charter to address the needs of investors seeking to invest in the former Soviet Union.[40] This call led to the establishment of the European Energy Charter in 1991, through which many felt that "[W]estern energy dependence and security of supply would be safeguarded by the creation of a privileged relationship of investment and trade between East and West."[41] However, because the Charter was only a political statement without any binding legal force,[42] calls for an enforceable multilateral

38. Foreign investments in the energy sector are multiplying with private and state-owned energy companies entering foreign markets. *See* Smith, *supra* note 28, at 43. For instance, ARAMCO, Saudi Arabia's national oil company, is in a joint venture to consolidate downstream activities (refining and distribution) with U.S. companies Texaco and Shell. *See* Motiva Enterprises LLC, *available at* http://www.aramcoservices.com/inside/who/orgchart/motiva.html (last visited Dec. 10, 1998).

39. The European Community is the first to implement common regulations binding several states on investments in the electricity sector. *See* Council Directive 96/92/EC, 1997 O.J. (L 207) 20 [hereinafter EU Directive].

40. *See* Thomas Wälde, *Introductory Note*, 34 I.L.M. 360, 361 (1995).

41. *Id.* at 362.

42. Title IV, first paragraph of the European Energy Charter notes that the Charter is "not eligible for registration under Art. 102 of the UN Charter." *Id.* The European Energy Charter is reproduced in Thomas W. Wälde & G. Ndi, International Oil and Gas Investment: Moving Eastward? 360 (1994). The European Energy Charter "represents the first formal step in the Energy Charter process, a statement of major principles which the signatories declare they wish to pursue as states and a set of guidelines/signposts for the subsequent negotiations of a 'Basic Agreement'–later to become the 'Energy Charter Treaty'." Wälde, *supra* note 40, at 362.

agreement on energy investment stirred. This eventually led to the development and signing of the ECT in 1994.

Changes in energy production over the last ten years also precipitated the need for an agreement such as the ECT to fill the void left both by the BIT exceptions and the lack of any binding international instrument in the protection of energy investments. At the time of the ECT negotiations, the energy industry was being shaped by several fundamental trends, all of which continue today. First, like the global economy in general, the energy sector is undergoing liberalization. Second, governments are deregulating their domestic energy sectors to open the way for broader activities by energy companies. Third, to promote better service for consumers, governments are also developing competitive markets within which these energy companies can function. Fourth, to assist with liberalization and competition reforms, governments are beginning to withdraw from the role of sole energy producers and from supporting and relying on state-owned monopolies charged with energy generation, transmission, and distribution. In the end, these trends and reforms promote the growth and emergence of global energy supply companies,[43] in addition to creating many new investment opportunities for smaller companies.[44]

To implement the reforms and trends outlined above, states desperately need private investors. The global capital markets should, in principle, be more than adequate to provide all the needed financing for energy development to meet the growing demand. Unfortunately, the mobilization of private capital will be very difficult in countries that do not meet investors' criteria for a stable economy, market transparency, a well-founded legal framework, and properly regulated financial markets.[45] As a result, a government's role in reassuring the energy investor will be crucial.[46]

One major way to satisfy the needs of international energy investors is through a standardized multilateral agreement focused on their particular sectoral needs. The ECT does just this; it binds Parties to certain fundamental norms that international energy investors constantly seek. Specifically, the ECT calls on states to concentrate on the following:

- Legal and fiscal regimes founded on stable, transparent, and non-discriminatory criteria;
- Regulation that is fair, independent, and effective that finds a balance between necessary regulatory intervention and freedom of energy companies to act;
- A minimization of government bureaucracy and other opportunities for arbitrary government intervention; and
- The abolition of national preferences.[47]

B. Overview of the ECT's Main Provisions

At its core, the ECT aims to develop the Parties' energy sectors "through a comprehensive, multilaterally agreed set of rules that promotes and protects foreign investment, international trade and market principles and sound environmental guidelines."[48] Specifically,

43. *See* G8 Energy Ministerial Business Consultation Meeting, The Business View of Our Energy Future 2 (1998) [hereinafter G8 Energy Ministerial Meeting].
44. *See* Joint Paper, *supra* note 9, ¶ 41.
45. *See* G8 Energy Ministerial Meeting, *supra* note 43, at 3.
46. *See* Joint Paper, *supra* note 9, ¶ 39.
47. *See* G8 Energy Ministerial Meeting, *supra* note 43, at 3.
48. Forsyth, *supra* note 5.

the treaty establishes a legal framework promoting long-term cooperation in the energy field, based on complementarities and mutual benefits.[49] Though the treaty is sector-specific, it defines "Economic Activity in the Energy Sector" broadly enough to include every possible transaction that an energy investor could conceive.[50]

The ECT's breadth of protections is similar to that of a BIT, except that its provisions focus on the particularities of the energy sector. The ECT avoids the use of general language, and instead specifies the particular rights or prohibitions within the area described. This is very unlike the U.S. Model BIT, which lays out its terms in shorter, more general language. Substantive clauses in the ECT include protections against trade-related investment measures,[51] unfair competition,[52] and restrictions on the transit of energy materials and products.[53] In addition, and similar to many U.S. BITs, the ECT contains binding provisions that address key personnel,[54] compensation for losses,[55] expropriation,[56] and capital transfers.[57]

C. Pre-Investment Regime in the ECT

The ECT's pre-investment protections take the form of soft-law obligations by state parties. This was necessary because the Treaty's development almost stopped after a disagreement erupted between negotiators concerning the language of these provisions.[58] Instead of pressing the issue, proponents of harder language agreed to leave the negotiations for binding pre-investment provisions to a Supplementary Treaty, negotiations for which were to start after the signing of the primary ECT text.[59]

---

49. ECT, *supra* note 4, art. 2 (giving purpose of the Treaty).

50. *Id.* art. 1(5) (listing protected activities in the energy sector to include exploration, extraction, refining, production, storage, land transport, transmission, distribution, trade, marketing, and the sale of certain energy materials and products).

51. *Id.* art. 5. This article provides foreign investors protection against government measures or domestic laws that force the investor to purchase a certain quantity of domestic goods, or restrain the investor's ability to import goods necessary for local production and use or export. The United States felt that the ECT prohibitions on TRIMs and performance requirements were substantially weaker than those in the U.S. Model BIT text and various other BITs concluded between the United States and other states. As the United States articulated, "[i]n the ECT, investor-state dispute settlement is limited to performance requirements imposed on already established investment. Thus, the Treaty does not prohibit host government performance requirements imposed on new investment as a condition of government approval." State Department Position Paper, *U.S. Problems with the European Energy Charter Treaty Text* (released in Lisbon on 16–17 December 1994).

52. ECT, *supra* note 4, art. 6 (anti-competitive behavior is not subject to either the investor-state (art. 26) or state-to-state (art. 27) dispute settlement system).

53. *Id.* art. 7. The transit of energy materials is one of the most important protections provided in the ECT. Already, Russia has called upon the ECT Secretariat to help it resolve a dispute with Ukraine over Ukrainian measures that Russia contends place undue burdens on the transit of energy materials through Ukraine. *See Russia Urges Charter Intervention*, EC Energy Monthly, Mar. 1, 1996, *available at* 1996 WL 8693485.

54. ECT, *supra* note 4, art. 11.

55. *Id.* art. 12.

56. *Id.* art. 13. To provide the strongest protection for investors, article 13(3) reads, "[f]or the avoidance of doubt, Expropriation shall include situations where a Contracting Party expropriates the assets of a company or enterprise in its Area in which an Investor of any other Contracting Party has an Investment, including through the ownership of shares." *Id.*

57. *Id.* art. 14.

58. *See* Wälde, *supra* note 40, at 363.

59. ECT, *supra* note 4, art. 10(4) (mandating that Supplementary Treaty negotiations start no later than January 1, 1995).

The compromise between the hard and soft law provisions may also be seen as a broad compromise between government and industry.[60] At the time of the compromise many governments were most concerned with the imposition of free, non-discriminatory access conditions against them. These conditions would result in a substantial limitation on their freedom of action over resource protectionism and the protection of infant or ailing national industries. On the other side of the compromise were investors, who were concerned with political risk once their investments were made and became hostage to national policy. Though this compromise theory does not completely represent the views of all states (especially those seeking harder pre-investment language), it does represent a possible difference of perspective between the priorities for governments, as compared to the priorities for investors.

Even with the soft law compromise, states still agreed to significant provisions governing pre-investment obligations within the main ECT text. As a start, the ECT lays out the Parties' ultimate goal: the most favorable treatment possible, including national or MFN treatment, to foreign investors in the establishment of investments.[61] In addition, the treaty obliges states to submit to the ECT Secretariat a report summarizing all current laws, regulations, or other measures relevant to exceptions to national or MFN treatment in the making of investments by foreign investors.[62] Finally, of course, the ECT mandates the negotiation of a Supplementary Treaty to place establishment rights into a binding international agreement.[63]

The ECT also recognizes the distinct difference between pre-investment and post-investment provisions. Accordingly, the Treaty has a separate definition governing pre-investment activities. In the ECT, "Making of Investments" means "establishing new Investments, acquiring all or part of existing Investments or moving into different fields of Investment Activity."[64] In contrast, "Investment" means "every kind of asset, owned or controlled directly or indirectly by an Investor."[65] The difference lies in the positioning of an investor: an investment shows that the investor has subjected herself to the regulatory hold of the state, while "Making of Investment" means that the investor still maintains full power over a decision on whether to forfeit finances for an asset. The line between "Making of Investment" and "Investment" is obviously crucial since the treaty's binding obligations and investor protections cannot be triggered until the latter takes place.[66]

In the energy sector, a determination of when an investment is actually made, and thus eligible for protection, can be a difficult process due to the lengthy time frame required for

60. *See* Wälde, *supra* note 40, at 363.

61. ECT, *supra* note 4, arts. 10(2), (3).

62. *Id.* art. 10(9).

63. *Id.* art. 10(4).

64. *Id* art. 1(8). Please note that capitalized terms refer explicitly to the ECT definitions.

65. *Id.* art. 1(6).

66. Specifically, only articles falling under Part III of the ECT can be taken to arbitration by the investor when a dispute arises between the investor and the state. *See id.* art. 26(1). Part III includes: TRIMs (as incorporated into article 10); national and MFN treatment of investments once made (article 10); key personnel (article 11); compensation for losses (article 12); expropriation (article 13); transfers related to investments (article 14); and subrogation (article 15). Disputes over the following are not included in Part III (and thus are subject to the article 27 state-to-state negotiation process): competition (article 6); transit of energy materials (article 7); transfer of technology (article 8); access to capital (article 9); sovereignty over natural resources (article 18); and the environment (article 19).

the development of energy projects. One scholar relies on the provision in the definition of investment pertaining to a right conferred by law as the triggering action after which an investment is made for purposes of the ECT.[67] Accordingly, any activities leading up to the right conferred falls under pre-investment.[68]

Another way to consider the line between pre-investment and post-investment requires an understanding of how the energy sector operates through a series of interim investments. This understanding shows that the lack of an enforceable, pre-investment regime within the ECT is not a problem because the energy sector necessarily demands smaller, mini-investments up until the final stage of a full and final investment.[69] Thus, "once the threshold of the investment definition under Article 1(6) is crossed, investments are covered, even if they are part of a sequence from preliminary to final investment."[70] Anything not crossing the investment definition in Article 1(6) does not qualify for protection, and thus falls necessarily within the pre-investment stage.

The ECT's pre-investment protections are further alienated by the cross-reference found in the definition of investment to "Economic Activity in the Energy Sector."[71] Anything deemed to be an investment in an "Economic Activity in the Energy Sector"[72] is protected by binding provisions subject to international arbitration.[73] This broad definition is significant because it recognizes that the activities leading up to the commencement of commercial activities are substantial and that investors need to be protected for these activities.[74] As a result, this further diminishes the pre-investment articles and enhances the scope of protections afforded to activities falling under the definition of investment, as discussed in the previous paragraph.

This view of pre-investment seems at odds with the traditional idea of establishment rights, that being non-discriminatory regulations governing the ability of investors to access an investment opportunity. In the energy sector, this means non-discriminatory criteria for the granting of licenses or authorizations to make an investment, as laid out in ECT articles 10(2) and 18. Within the context of the ECT, I think pre-investment rights could include both the "activities leading up to an investment" in addition to non-discriminatory criteria for accessing investment opportunities. This is because of the naturally long process re-

67. Wälde, *supra* note 14, at 280.

68. *Id.* This may include studies, visits, the opening of a business development office, and any other activity related to business development risk.

69. *Id.* at 305.

70. *Id.*

71. The ECT's definition of Investment is very inclusive and includes "*every* kind of asset, owned or controlled directly or indirectly by an Investor." ECT, *supra* note 4, art. 1(6) (emphasis added). The definition goes further to include both tangible and intangible property, stock and other representations of equity or debt, money claims and returns, intellectual property, and any right conferred by law or contract or by virtue of any licenses and permits granted pursuant to law to undertake any "Economic Activity in the Energy Sector."

72. "Economic Activity in the Energy Sector" means any economic activity concerning exploration, extraction, refining, production, storage, land transport, transmission, distribution, trade, marketing, or sale of Energy Materials and Products, except those included in Annex N1 (specific exception for the United States and Canada), or concerning the distribution of heat to multiple premises. ECT, *supra* note 4, art. 1(5).

73. Article 26(1) grants an investor, who has a dispute with a state over an investment, the right to submit the dispute to resolution in the state's local courts, in accordance with any other agreed upon forum, or in accordance with the ECT's international arbitration provisions. The ECT is powerful because each state gave "its unconditional consent to the submission of a dispute to international arbitration" when becoming a party to the treaty. ECT, *supra* note 4, art. 26(3).

74. *See* Wälde, *supra* note 14, at 280.

quired in the development and assessment of any new energy project. To be treated equally with domestic investors, foreign investors need certain guarantees. These guarantees should be aimed at enabling foreign investors to position themselves in the country in such a manner that will make them as competitive in winning the authorization to undertake the energy project as their domestic counterparts. Therefore, binding provisions granting investors the right to enter a state for purposes of "establishing, developing, administering, or advising" on a potential new investment are needed.[75] This need for proper positioning within a domestic market is not adequately handled by the ECT's current soft language.

Because of the soft language used, the binding nature of the ECT's pre-investment provisions is questionable. The difference in language used in the establishment articles signifies that the Treaty's drafters did not intend those provisions to have the same binding force as the harder protections once an investment was already made.[76] Some believe these soft-law obligations only require a state to expend best efforts towards meeting the obligations.[77] What constitutes a breach of these obligations? One legal scholar opines that "if a government seriously, repeatedly and on a central level, does not make reasonable efforts to comply with the pre-investment obligations, then it breaches the Treaty.... The Treaty in fact opens up a vista of government liability for pre-investment conduct analogous to private-law liabilities for bad faith conduct in the pre-contractual stage."[78] Specifically, the ECT's pre-investment articles are not subject to the mandatory international arbitration clause found in Article 26, but instead are subject to inter-state consultation and arbitration procedures found in Article 27.[79] So, if a Party believes that another Party is failing to even expend some effort to meet the pre-investment provisions, it can call for direct state-to-state consultations on the matter. An investor cannot unilaterally challenge the efforts taken by a Party to meet its pre-investment obligations. This mechanism is clearly weaker than the binding arbitration procedure found in Article 26, a sign that the ECT really did not want its establishment provisions to be strictly binding and enforceable by individual investors.

IV. Supplementary Treaty

A. Goals and Objectives

Even with the extensive soft-law protections and broad definition of investment, the ECT does not completely address the entire scope of rights related to the establishment of energy investments. Therefore, Article 10(4) obligates Parties to start negotiating a Supplementary Treaty whose goal is to specify conditions for pre-investment.[80] Originally, the Supplemen-

75. This language is taken directly from U.S. Model BIT art. II(3).

76. *Id.*

77. *Id.*

78. *Id.*

79. As mentioned earlier in note 66, not all ECT provisions are subject to the investor-state dispute settlement process in article 26. The remaining necessarily falls under article 27, the state-to-state dispute mechanism process, except for specific articles that are not subject to any form of formal dispute settlement process. These further exceptions include disputes over the environment (article 19); competition (article 6); and interim measures on trade matters (article 29). The article 27 state-to-state process requires states to negotiate through diplomatic channels as a first attempt towards resolving a dispute between them. Where this fails, one state may request the formation of an ad hoc tribunal to settle the dispute between them. The arbitral award declared by the tribunal shall be final and binding on the states involved in the dispute. ECT *supra* note 4, art. 27(3)(h).

80. *Id.* art. 10(4).

tary Treaty was to be concluded by the start of 1998,[81] but to date, no draft version of the Supplementary Treaty is available, and it does not appear likely that a treaty will be concluded.[82] Some reports provide insight into the most difficult issues handled in the negotiations.

Fundamentally, the Supplementary Treaty would aim to extend national and MFN treatment to the establishment of energy investments. Specifically, one report states that the Supplementary Treaty will "extend national treatment or most favored nation treatment to the pre-investment phase, defined as 'establishing new investments, acquiring all or part of existing investments or moving into different fields of investment activity.' "[83] The ECT in Articles 10(2) and 10(3) currently obligates Parties to endeavor to accord foreign investors the more favorable of national or MFN treatment in the establishment of investments.[84] The Supplementary Treaty will strengthen this by mandating Parties to afford such treatment; endeavoring will no longer be enough.[85] A successful completion to the Supplementary Treaty negotiations would have marked the most progressive achievement in the protection of investment rights since the ratification of NAFTA. No other multilateral agreement to date would provide such a broad and secured right to establish investments in the energy sector.

Several early indications from the Energy Charter Secretariat, the body created by the ECT and entrusted to ensure its compliance, suggested that the negotiations on the Supplementary Treaty were heading in the right direction. First, according to the Secretariat, states agreed not to introduce any new discriminatory measures with respect to pre-investment conditions, and to gradually remove old ones.[86] The Secretariat further elaborated, "[r]elations between members of the international energy community will be more transparent, predictable, efficient, and fair" with the creation of the Supplementary Treaty.[87] The Secretariat further predicted "an even better allocation of resources, which will ensure long-term sustainable economic growth"[88] from the better investment climate developed through the Supplementary Treaty. Despite the early optimism, the Supplementary Treaty was not completed, and so a further examination of the issues is warranted.

B. Exceptions

Several reports suggested that the key to successfully completing the Supplementary Treaty would have been the ability of states to register exceptions.[89] Of course, any excep-

81. *Id.* (calls upon states to finish the Supplementary Treaty by January 1, 1998).

82. E-mail from Lise Weis, Energy Charter Secretariat, to author (Dec. 6, 1998) (on file with author).

83. *Negotiations Start*, *supra* note 8.

84. ECT, *supra* note 4, arts. 10(2), (3).

85. Telephone Interview with Mr. Ervik, Energy Charter Treaty Secretariat (Nov. 18, 1998). According to one official at the ECT Secretariat, the current version of the Supplementary Treaty text is analogous to ECT articles 10(2) and 10(3) with the word "endeavor" deleted.

86. Press Release, Energy Charter Secretariat (Dec. 22, 1997); *see Energy: Fifty Countries Move Towards Energy Licensing Treaty*, OPECNA News Service, *available at* 1997 WL 16356301.

87. Press Release, Energy Charter Secretariat, *supra* note 86.

88. *Id.*

89. *See Energy Charter: Talks on Next Generation Treaty Under Way*, Eur. Rep., Mar. 12, 1997, *available at* 1997 WL 13046581. An annex to the Supplementary Treaty will contain country-by-country exceptions to the rules of national and MFN treatment for the establishment of energy investments. *See also Negotiations Start*, *supra* note 8 (exemptions in the pre-investment phase will be key).

tions accepted by the Parties would be legally binding on all. The possibility of certain states receiving more favorable treatment towards those exceptions is not allowed: an effect of extending MFN status to the pre-investment phase. The ECT introduced the possibility of pre-investment exceptions, but bottom-up. That is, the ECT assumes that national or MFN treatment does not apply to any pre-investment energy activity, and leaves it to the individual states to declare the specific sectors within which this type of treatment will be accorded to foreign investors. In Article 10(6), the ECT grants states the right to unilaterally declare which sectors they will grant foreign investors national or MFN rights in the establishment of an investment.[90] Of course, Article 10(6) only calls for a voluntary declaration, and does not obligate states to extend national or MFN treatment in any activity. The Supplementary Treaty will likely work in reverse (or top-down): it will bind states to grant national or MFN treatment in all energy activities, except for the specific exceptions enumerated in an annex. States seeking to place individualized exceptions in the annex will undoubtedly be forced to justify the move, especially if other parties opt out of placing similar exceptions.[91]

During the Supplementary Treaty's negotiation, an extensive survey of current exceptions to national or MFN treatment by Parties was conducted.[92] Under the ECT, parties must notify the Secretariat of all current exceptions.[93] Of the fifty ECT parties, only twelve reported no exceptions.[94] The other ECT parties registered over 100 exceptions in matters such as privatization,[95] land ownership,[96] registration or screening,[97] and reciprocity.[98] After much debate, most of these exceptions were grandfathered into the Supplementary Treaty.[99] Any exceptions included in the Supplementary Treaty are still subject to the requirement of best efforts for removal.[100] In any event, it is doubtful whether these exceptions will

90. ECT, *supra* note 4, art. 10(6).

91. *See Negotiations Start*, *supra* note 8, at 45.

92. The Energy Charter Treaty, *Non-Conforming Measures Maintained by a Contracting Part and Any Commitments with Regard to Them*, *at* http://www.encharter.org/English/Country/index.html (last visited Jan. 27, 2001) [hereinafter *Non-Conforming Measures*]; *see also* Joint Paper, *supra* note 9, ¶ 48.

93. ECT, *supra* note 4, art. 10(9).

94. *Non-Conforming Measures*, *supra* note 92.

95. Sixteen of the fifty ECT Parties have a total of twenty-six exceptions to the treatment of foreign investors in privatization. All of the exceptions related to the initial sale of state-owned assets, and not the subsequent resale of those assets (shares or property). *See id.*; *see also infra* discussion on privatization as an outstanding issue in the Supplementary Treaty negotiations.

96. Twenty ECT states have one exception each to the rule of non-discrimination of foreign investments in land purchases and leasing. These exceptions could significantly hinder the establishment of foreign investments since private land and property ownership is one of the fundamental elements in the formulation of private capital. In addition, property is frequently the sole collateral used by investors when obtaining credit. To counter the negative effects of these property ownership exceptions, states should create viable alternatives to ownership by means of reliable, long-term lease arrangements. Such contractual arrangements can then be used as the collateral often needed to secure credit. *See Non-Conforming Measures*, *supra* note 92.

97. Of all the exceptions to non-discrimination, the largest number relate to the registration and screening of investors and investment initiatives. Twenty-nine ECT states have sixty-seven exceptions here, the majority of which provide procedural differences between domestic and foreign investors in company registrations. Small differences in licensing procedures also exist. *Id.*

98. The Supplementary Treaty admits about nine exceptions based on reciprocity by seven contracting parties/signatories and the EU. These will be removed as other exceptions are removed, given the Treaty's general requirement for equal treatment and non-discrimination. *See id.*

99. Telephone Interview with Ervik, *supra* note 85.

100. ECT article 10(5)(b) reads, "Each Contracting Party shall, as regards the Making of Investments in its

actually hinder the admission of investments into ECT states. Studies show that the power to screen and refuse foreign investments has been used minimally by ECT states.[101] Even so, risk is the investor's enemy, and every effort should be taken by states to reduce investors' doubts concerning the use of discriminatory measures against them.

C. Outstanding Issues

Several crucial issues delayed or contributed to the failure to realize the completion of the Supplementary Treaty: privatization, de-monopolization, economic integration agreements, and environment and labor issues. For several countries, these issues rise to the level of deal-breakers if not addressed successfully. They relate to the tension states are facing between their traditionally strong hold on domestic energy resources and production, and the need to grant foreign investors open rights to establish investments.

These issues are further exacerbated by the spectrum of practice currently underway among the negotiating states. On the one end are the economies of transition in eastern Europe and central Asia, who just recently began moving their energy sectors out of a state-dominated regime to one that allows the participation of private investors (not necessarily foreign private investors).[102] On the other side of the spectrum are the states of western Europe, who have very evolved regulatory schemes to handle issues relating to the private ownership of energy industries and activities, in addition to the common EU rules governing the liberalization of the electricity sector. I do not want to give the impression that any one group of countries bogged down the negotiations in any way. Instead, I believe that the variance in state practice among the negotiating states highlights a challenge to all future sector-specific investment regimes, and should be understood in order to better handle similar issues in the future.

A closer examination of the key issues sheds light on what states are troubled with as they balance their traditional absolute sovereign power to control the national energy sector with the growing need for international investors to be placed on an equal and protected footing in the establishment of investments.

1. *Privatization*

Once the sole domain of national governments, energy activities are now being deliberately handed over to the private sector. Through the liberalization process, many traditional state functions are slowly being transformed. States now realize that the private sector is often more capable than the government at providing reliable energy services at competitive prices.[103] Through privatization, the state opens the door to potentially billions of dollars in private investment.

The question of privatization is not a new one. During negotiations on the Multilateral Agreement on Investment (MAI), states needed to focus on this very same question. Though a final text was not agreed upon, one provision seemed well accepted: nothing in the MAI would be construed as imposing any obligations on a state to privatize.[104] In addition, the

own area, endeavor to . . . progressively remove existing restrictions affecting Investors of other Contracting Parties." ECT, *supra* note 4, art. 10(5)(b).

101. Joint Paper, *supra* note 9, ¶ 49.

102. For instance, Russia began its privatization program in 1992 with Presidential Decrees Nos. 922, 923, and 1334 entitled *Restructuring and Privatization of the Russian Power Industry.*

103. Joint Paper, *supra* note 9, ¶ 54. When competition is permitted, there is evidence that private firms are more efficient than publicly owned companies.

104. Draft MAI, *supra* note 2, at 27.

draft MAI set forth four different alternatives on the method by which states may privatize and grant special treatment to either domestic investors or to themselves through the retention of a golden share of the privatized assets.[105] These alternatives demonstrate the degree to which there was disagreement among the international community on the treatment foreign investors should receive in privatizations.

The Supplementary Treaty's handling of the obligation to privatize was similar to the draft MAI. In the Supplementary Treaty, each state reserved the right to choose whether it will privatize any assets in its energy sector. There would be no obligation to privatize, or alter the ownership of any state assets in the Supplementary Treaty.[106]

After a state chooses whether to privatize, further considerations make the privatization issue especially contentious because of the strategic nature of energy assets. Two questions need to be answered. First, can the state retain a lion's share of the assets for itself? Second, can the state grant its nationals preferential treatment in the asset sell-off? Related to the second question is the issue of whether the state can maintain the preferential treatment for nationals in any subsequent re-selling of the assets.

A preliminary solution to the first question, on whether a state may retain a certain portion of the privatized assets, was found at a Supplementary Treaty negotiation session in 1995. Prompted by Russia, which has plans to sell off a large part of its energy sector companies, it was decided that a state wishing to maintain a golden share of any currently state-owned sector was entitled to do so. The delegates concluded that keeping a lion's share amounted to normal business practice and was not discriminatory, and so no exception would be needed for such practice.[107]

An answer to the second question on the issue of maintaining shares for domestic investors was not as straightforward. Delegates decided that it would be acceptable for a state to restrict a certain portion of the initial issuance of shares to domestic investors. However, restrictions placed on the sale of shares to any foreign investor through a secondary market would likely be problematic and counter to the aims of national treatment.[108] Subsequent negotiations have narrowed the scope of this compromise. Economies in transition will be allowed to deviate from national or MFN treatment for a period of time, and they may grant preferential treatment to their domestic investors in the initial privatization transaction.[109] In return, the states must comply with extensive reporting requirements and move to eliminate all future preferential treatment in future privatizations.[110] In addition, no state can place restrictions on the resale of privatized assets and shares.[111]

2. *De-Monopolization*

Distinct from the process of privatization is the de-monopolization of companies resulting from economic liberalization. At its core, de-monopolization entails the opening of a

105. *Id.* at 28.

106. E-mail from Lise Weis, *supra* note 82.

107. *Negotiations Start*, *supra* note 8, at 45.

108. *Id.*

109. Telephone Interview with Ervik, *supra* note 85. Specifically, the privatization exception in the Supplementary Treaty "would allow countries listed in an annex to reserve some or all of the shares or assets owned by the state, or of its state enterprise that it is privatizing, to its own nationals (or to sell or otherwise dispose of such shares or assets to its own investors on preferential terms). E-mail from Lise Weis, *supra* note 82.

110. Telephone Interview with Ervik, *supra* note 85.

111. *Id.* A technical exception to this was allowed for Gazprom, Russia's national petroleum company.

sector to competition before the privatization of state monopolies.[112] By de-monopolizing, a state forces the monopoly to break down and participate in that competitive market. Of course, if a state decides to keep intact a public (state-owned) monopoly, there is no issue since this eliminates the chance for foreign investment. Like privatization, nothing in the Supplementary Treaty will obligate a state to de-monopolize.[113] On the other hand, if the state wishes to maintain and grant preferential treatment to a private domestic energy monopoly, then this should be listed as an exception in the Supplementary Treaty.[114]

The more perplexing prospects for foreign investors arise when the state commits to restructuring, but not privatizing, its monopoly. In this case, to what extent can new regulations be allowed to favor a domestic company over its foreign competitor? This often arises because de-monopolization prompts the sector to attract competitors, many of whom will be foreign investors.[115] Of the states negotiating, France is one of the most concerned with this.[116] Because of a directive mandating the liberalization of the EU electricity market,[117] France must open up its market to foreign investors. This forces France to restructure its state-owned electricity company, Electricité de France (EDF). In negotiating the Supplementary Treaty, France is most concerned with how far its new regulations can favor EDF over non-EU investors in the French market.

To facilitate the market, the state needs to show everyone that one set of rules governs all activities and players. There cannot be any deviation to favor domestic or state-owned companies over foreign-held entities. This principle is set in the ECT. Also, since de-monopolization requires the state to absorb new players, it must fairly present any new licensing opportunities to any interested investor. The state needs to avoid falling into the trap of favoring its long-time monopoly, something many states have trouble doing. Moving to competitive markets is not easy when you are responsible for promoting competition against yourself.

Addressing the previous situation is different from addressing the situation where a private company has market dominance due to its size. In this case, no exception to the Supplementary Treaty is needed. Instead, the state must police the monopoly using national competition and antitrust rules.

During the Supplementary Treaty negotiations, delegates generally felt that the rules on de-monopolization should not be severe since de-monopolization, in itself, is a step in the right direction.[118] This makes sense because de-monopolization starts a process towards competition. With competition, the opportunities for investment grow, and so the likelihood that foreign investors will be able to access the domestic energy market will also

112. There are particular reforms that are essential or highly desirable before privatization. Among these is the restructuring of the enterprise to be privatized so that it no longer has a monopoly or dominant market position. *See* Joint Paper, *supra* note 9, ¶ 62.

113. E-mail from Lise Weis, *supra* note 82. The Draft MAI also reserves a state's right to maintain or designate a monopoly. Draft MAI, *supra* note 2, at 32.

114. *Negotiations Start*, *supra* note 8.

115. If a state enterprise is allowed to maintain its monopoly position, but also engages in competition, the economic distortions may be very damaging. As a result, competition policy must give a high priority to separating justifiable monopoly activities from those activities where competition can be introduced. *See* Joint Paper, *supra* note 9, ¶ 5.

116. *Negotiations Start*, *supra* note 8.

117. *See* Council Directive 96/92/EC.

118. *Negotiations Start*, *supra* note 8.

subsequently grow. Few ECT states can sustain a competitive energy market without foreign investors. Because of this, it is understandable why negotiators of the Supplementary Treaty will not press for severe rules governing de-monopolization; establishment opportunities can be expected to evolve in time out of necessity. The current Supplementary Treaty provisions reflect this by making the de-monopolization articles soft-law provisions and not binding obligations on the states.[119]

3. *Economic Integration Agreements*

A major concern for non-EU states is how the Economic Integration Agreement (EIA) exception within the ECT may affect them. Article 24(4) of the ECT grants a general exception to EIAs.[120] At the moment, there is no EU-wide rule on investment, and so other Supplementary Treaty states may be worried that the EIA clause would allow the EU to pass a subsequent law on investment that could be discriminatory towards non-EU states.[121] This concern, in my opinion, is far-fetched since EU states realize that such a move could devastate their hopes of securing investments in non-EU states. A non-EU state can react and place a reciprocity exception on access to energy investments if the EU devises more favorable terms for its Members.

4. *Environment and Labor*

The most recent setback to negotiations came from the insistence by certain negotiators for the incorporation of environmental and labor standards into the Supplementary Treaty.[122] Apparently, this new issue has diminished hopes of a successful completion to the Supplementary Treaty by the end of 1998.[123] The ECT itself says very little about labor,[124] but it does have a separate article[125] and protocol[126] on the environment. The inclusion of extensive environmental provisions and safeguards is understandable since the environmental costs to energy development can be tremendous. These environmental provisions replicate most international agreements in that they seek to balance the state's interest in developing the energy sector with environmental protection. Key to the ECT's environmental regime is the polluter pays principle.[127] This is part of the parties' obligations to

119. Telephone Interview with Ervik, *supra* note 85.

120. ECT article 24(4) reads, "The provisions of this Treaty which accord most favoured nation treatment shall not oblige any Contracting Party to extend to Investors of any other Contracting Party any preferential treatment: (a) resulting from its membership of a free-trade area or customs union." ECT, *supra* note 4, art. 24(4).

121. During the ECT negotiations, the United States aggressively pushed to change the language of ECT article 25 (Economic Integration Agreements). The United States took the position that such a provision could foster the creation of special relationships between the EU and central and eastern European states to the exclusion of non-European Contracting Parties, including the United States. *See* Fox, *supra* note 7, at 198.

122. Telephone Interview with Ervik, *supra* note 85.

123. *Id.*

124. The only labor related provisions in the ECT refer to the right of investors to bring in key personnel. ECT, *supra* note 4, art. 11

125. *Id.* art. 19.

126. The Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects, Dec. 1994, 33 I.L.M. 445 (1995), lays out the policy principles agreed to by ECT Parties in the areas of energy efficiency, environmental impact, and cooperative efforts aimed at balancing the need for sustainable energy development with environmental protection.

127. ECT, *supra* note 4, art. 19(1). The polluter pays principle requires that whoever is the source of pollution must also be the one to pay for it, including transboundary pollution.

promote market-oriented prices reflecting the environmental costs and benefits throughout the Energy Cycle.[128] Overall, the environmental provisions in the ECT are very state-friendly, and thus authorities maintain a great deal of discretion to manage their environmental policies as they see fit.[129] This is most evident since article 19 (Environmental Aspects) is not subject to either the state-to-state or investor-state dispute settlement provisions.[130]

Like privatization and de-monopolization, labor and environmental issues were also being discussed within the MAI. In the MAI negotiations, there were four different alternatives on how environmental standards should be handled in the establishment of investments.[131] The general theme throughout the alternatives rests on the inappropriateness of attracting foreign investment through the waiving, derogating, or relaxing of environmental standards.[132] Trying to pin down an acceptable form of such a provision for the energy sector is likely to be quite difficult, especially when considering the variation in environmental standards among the states present at the negotiations.[133]

A common position on energy sector labor standards among ECT states seems to be more unattainable than a common position on the environment. As a starting point, nothing in the main ECT text even addresses the slightest or softest obligations by states on labor. Therefore, no common position is available from which states can negotiate pre-investment labor protections. In addition, the wide spectrum of labor standards among the parties negotiating the Supplementary Treaty will likely make it difficult for them to agree on a standard set of obligations from which no state can derogate when seeking to attract foreign energy investors. As a result of these difficulties with labor and environmental standards, it is understandable why one official at the ECT Secretariat remarked that negotiations on the Supplementary Treaty are currently in "suspended adoption."[134]

V. Conclusion

While the concept of sector-specific pre-investment rights may seem narrow in scope, it in fact reaches broadly to threaten one of a state's most fundamental protections: the

128. *Id.* art. 19(1)(a). This is an extension of the polluter pays principle and is a foundation for any future competitive market in electricity. The FSU has been plagued by lower-than-cost power being sold to consumers, thus making any profitable operation by private investors impossible (since electricity tariffs are set by the state). This provision calls upon states to move away from a subsidized electricity sector and to force consumers to pay the real cost of electricity.

129. Article 19(1) contains language emphasizing this. It calls for states to implement the polluter pays principle "with due regard to the public interest and without distorting Investment in the Energy Cycle or international trade." ECT, *supra* note 4, art. 19(1); *see also* Clare Shine, *Environmental Protection Under the Energy Charter Treaty, in* THE ENERGY CHARTER TREATY, *supra* note 7.

130. *Infra* notes 66 and 79.

131. Draft MAI, *supra* note 2, at 54.

132. For instance, Alternative 2 currently reads, "A Contracting Party [shall] [should] not waive or otherwise derogate from, or offer to waive or otherwise derogate from [domestic] health, safety or environmental [measures][standards] . . . as an encouragement for the establishment, acquisition, expansion or retention of an investment of an investor." *Id.*

133. The environmental standards within the OECD (within which the MAI is being negotiated) are much more harmonized, as compared to the environmental standards among the ECT states (the EU at one extreme with excellent environmental safeguards, and the FSU at the other with much weaker environmental protections).

134. Telephone Interview with Ervik, *supra* note 85.

right to determine who can access its most strategic investment opportunities. Coupled by the need for capital on one end, and the move towards global competition in traditionally closed sectors on the other, states find themselves more apt to cooperate and resolve the issues most vital to securing future inward investments. The need for sustainable development and steady growth forces states to find new areas that can lure needy foreign capital. The energy sector provides a major source of new investment opportunities.

Opening the energy sector to foreign investors is not the same as opening the retailing market. Considerations of national security, social welfare, and national pride make a government's willingness to cede control over its vital industries more difficult than in other sectors. This explains the lack of any global arrangement for the protection of investments in the energy, as well as other, sectors. Furthermore, the deep-rooted sovereignty concerns that states have over the energy sector lead them to carve out specific exceptions even within the narrow framework of bilateral investment treaties. In short, nothing to date has succeeded in persuading states to give up a little of their total discretion in controlling energy sector investments, not NAFTA, not the BITs, and not even the Treaty of Rome.

The ECT's Supplementary Treaty hopes to break tradition by offering states a compromise on their most pressing concerns. Because of its top-down approach, the Supplementary Treaty openly recognizes one of the market's truisms: a well-regulated market will function better than no market at all. The top-down approach grants investors more protections in non-discriminatory access rights than any other previous investment regime. Of course, the state still retains its complete sovereign power to regulate the market in a non-discriminatory manner. In the energy sector, this means that the government still sets the rules for tariffs, competition, consumer-safety, labor, and environmental protection, among others. In effect, the Supplementary Treaty will actually force states to use more of their inherent sovereign power in regulating the energy sector than has been used in the past.

What can be learned from the ECT and Supplementary Treaty process for other sector-specific investment treaties? A lot, I believe.

First, as a threshold matter, states can now see that there are alternatives to the traditional BIT process. Specific considerations forced states to place detailed exceptions in each of their BITs. These exceptions do not negate the need for investment protection, however. What the ECT process shows is that certain sectors need special treatment, as compared to other sectors.

Second, the ECT process shows that sector-specific investment treaties are possible. This may seem like a terribly obvious conclusion, but I do not believe it is. The BIT sector exceptions signaled states' concerns that too much was at stake and needed to be addressed before for that specific sector could meet the BIT's obligations. The exceptions displayed the inherent protectionism states feel in these areas; a protectionism that they are not ready to disregard and throw out. Now, after a lengthy and complex process, a compromise was reached whereby state protectionism is still respected while investor protections are confirmed.

Third, the ECT's negotiation process also teaches a great deal about how future agreements can be reached. The process was explicitly divided into two categories of negotiations: pre-investment and post-investment. Within each of these categories, the Parties further narrowed the scope of their discussions to specific regulatory, investment, and trade issues. Within each issue, each state was able to express its position and register its concerns. This process shaped the intricate intersections within the ECT treaty. For instance, why is competition policy not subject to any dispute resolution, trade in energy materials is only subject to state-to-state dispute resolution, and expropriation is subject to investor-state dispute resolution? The differences highlight the particular needs of each issue, the degree to which each state wants to be bound by an international treaty, and necessary compromises needed to secure fundamental protections for the investor. The lesson to be learned from this exercise is that other sectors will necessarily need to be dissected into their component parts before a treaty can be concluded on them. This is the nature of international diplomatic negotiations in sovereignty-sensitive matters.

Fourth, the ECT process shows that there exists a real deep-rooted need for sector-specific investment treaties. The age of globalization means that there are no boundaries for an investor's money. Wherever an opportunity arises, there is bound to be someone ready to finance it, for the right return balanced with the risk taken. More often now, these investments are falling on the once-sacred ground of national governments. While the use of private companies to develop natural resources is an old proposition, the use of private companies to generate, transmit, and distribute electricity is not. This is happening now, and so a common market of players needs to be protected for this activity to continue. Other sectors are also opening up to foreign investors throughout the world. Consider the growth of telecommunications, water-treatment, and airline companies. They may all require their own investment treaties to address the particular issues involved.

Aside from the general lessons listed above, I believe a major achievement in the whole ECT process can be found in the negotiations for the Supplementary Treaty. That process also shows that a deliberate and flexible approach to regulating establishment rights can drastically improve the investment climate for all states involved. By differentiating among the various exceptions, the Supplementary Treaty forces states to take a hard look at what particular activities are most vital to them and warrant an exception to the general rule of non-discrimination in access rights. As mentioned earlier, this top-down approach necessarily frees up numerous other activities to potential foreign investors, activities that they did not have access to prior to the Supplementary Treaty.

Outstanding issues still plague Supplementary Treaty negotiations. This should not discourage states from following through with their ECT obligation to conclude a Supplementary Treaty. The latest issues of environment and labor highlight a trend with recent investment treaties and offer a lesson for the future. An accepted reality for all future investment treaties, whether they are bilateral, multilateral, or sector-specific, will be the need to address issues that all investments affect. Because of the sensitive relationship between energy and environment, a compromise here could serve as a model for future agreements. Therefore, since the ECT is considered to represent the state of the art in investment treaties, it should push ahead to meet this latest challenge.

I also support the Supplementary Treaty's approach to exceptions. Some may argue that allowing states to set forth exceptions actually works against the aim of the Supplementary Treaty. They may argue that the ECT and Supplementary Treaty were conceived exactly to address the exceptions taken in BITs, and it would be futile to have exceptions to the exceptions. I disagree. If the Supplementary Treaty manages to bind states to national and MFN treatment commitments in all "Economic Activity in the Energy Sector" except for a few particular activities, then it is a great victory for the international energy investor. Even the most recent multilateral agreement, NAFTA, does not do this. Never has an arrangement been reached whereby investors are enriched with access rights to numerous strategic areas in so many states.

From the lessons learned in the ECT and Supplementary Treaty process, I believe the prospect for more sector-specific investment treaties is bright. Even the United States, who did not sign the ECT, believed that the need for protected establishment rights warranted U.S. participation in the Supplementary Treaty. Investors around the world will keep demanding protections guaranteed under international law as they expand their portfolio of investments into sovereignty-sensitive and strategic investments outside their home states.